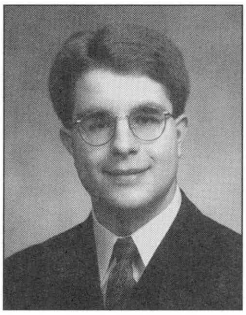
1-1-1999

The 1982 Debt Crisis and Recovery in Chile

Michael Margitich
Lehigh University

THE 1982 DEBT CRISIS AND RECOVERY IN CHILE

Michael Margitich



The financial crisis which struck Chile during the early 1980s was the most serious in its recent history and shattered the brilliant picture of economic prosperity observed in Chile during the years following the 1973 coup. In this article I attempt to analyze some of the major causes of the crisis, how they might have been avoided, and what was done to stimulate the recovery of the Chilean economy in the mid-to-late 1980s. I also discuss the measures taken in Chile since the crisis in order to assess the possibility of a reoccurrence of another severe economic crisis in Chile's future.

Prelude to the Crisis: "The Crisis Was Not Supposed to Happen in Chile..."

When the debt crisis hit Chile in the early 1980s, it was the last thing that Chile's economists expected to happen. As Whitehead states, "However widespread and forceful its impact, the Latin American debt crisis of the early 1980s was *not* supposed to happen in Chile...." (Whitehead, p. 117) The international financial community had not hesitated in placing Chile on a pedestal of sorts, categorizing it as "different" and somehow in better economic shape than the rest of its Latin American neighbors. Most late 1970s advocates of free-market economics believed that the long-term changes in economic philosophy that Pinochet's "Chicago Boys" (so named because they had studied economic policy at the University of Chicago) had brought upon Chile after the 1973 coup did indeed set Chile apart from the rest of the continent. Closest in economic performance and policy was Argentina, but even it was considered less committed to these so-called "neo-conservative" free-market economics and privatization issues. Chileans had created a strong foundation for bringing their economic philosophies into practice — Argentina simply did not have as thorough an understanding of these new concepts as Chile did. In addition, historians may debate on and on the issue of whether a dictatorship such as Pinochet's was a necessary condition for Chile's economic turnaround without reaching a conclusive resolution. However, it cannot be denied that Pinochet's administration *did* possess a great unity and determination, believing that it had "saved Chile from Marxism," and therefore internal friction and resistance was kept at a minimum. (Whitehead, p. 117) Arguably one of the greatest characteristics of Chilean history has been the government's ability to bring policies — especially those intended to restructure society as a whole — from initial design to implementation effectively. Pinochet's Chicago Boys all carried the same ideologies to the many policies implemented to further the concept of a free-market economy. These policies had the underlying goals of increasing the flexibility of Chile's economy and its ability to adapt well to external shocks. In addition, they attempted to create strong links with major sources of capital in the capitalist countries. The final result of these policies would ideally be economic growth and prosperity, which would in turn lead to a solidification of national pride among Chileans. By approximately 1980, Chile had every reason to believe that this great economic transformation had truly been brought about and that the Chicago Boys had worked their miracle.

Many other economic indicators added to the reassurance that Chile was riding high during Latin America's times of uncertainty. Throughout the rest of the world, public spending was on the rise and comprising a larger and larger percentage of the GDP of most countries. Between 1970 and 1980, public expenditure in Chile had peaked at 44.9 percent of GDP, but by 1980 that figure had been reduced by almost half to 23.1 percent. The rest of Latin America was increasing the size of its public sectors and running fiscal deficits while Chile was doing just the opposite. In 1980 Chile ran a *surplus* of 3.1 percent of its national income. (Whitehead, p. 118)

Inflation also was running rampant throughout the rest of Latin America during the late 1970s and early 1980s. In contrast, in 1981 Chile's consumer price index increased at a single digit rate (9.5 percent) for the first time in almost 20 years. Just five years earlier, the Chicago Boys had been struggling to bring down an inflation rate that had hit over 200 percent. Even more spectacular was the 1,000 percent hyperinflation that followed the 1973 military coup. Controlling inflation was one of the achievements that the Pinochet administration was most proud of and was a major source of increased confidence in its economic philosophies. (Whitehead, p. 119)

Interest rates told another encouraging story in Chile during the early 1980s. The rest of Latin America had held interest rates below the inflation level. This scheme was creating, in effect, *negative* real interest rates, which were actually penalizing the savers in the economy and greatly benefiting those who had borrowed funds. (Whitehead, p. 118) As economic models such as the Solow growth model illustrate, discouraging saving in an economy is generally not a recommended course of action for economic growth. But Chile was once again ahead of its Latin American counterparts with real interest rates which had become increasingly higher and more positive as the inflation rate dropped during the late 1970s. By 1980, these rates were not quite as high, but had settled in at the accepted "normal" rate of around 10 percent. Maintaining a respectable level of savings in the Chilean economy was another reason to expect continued growth and prosperity.

Finally, excessive foreign borrowing by Chile's South American neighbors was increasing at a very rapid pace during the 1970s. These countries consistently experienced high debt-to-service ratios throughout the decade. Before the 1973 coup, Chile was in the same position, suffering from extremely high external public debt. After the coup, Chile had very little access to international credit until 1977, and its external debt increased very slowly, if at all. In 1978, Chile *did* see an increase in external borrowing, but up until 1979 had still accumulated very little debt, mainly because the need for foreign borrowing wasn't as prevalent as in other Latin American nations. Chile's government was running a surplus which it could use to finance projects, and the government itself was attempting to reduce its level of economic intervention (and therefore needed less capital to fund such interventionist activities). (Whitehead, p. 120) With 1979 came a completely different story, however, which will be explained more fully in the next few sections.

Taking all of these factors into consideration, one would easily be inclined to agree with those free-market economists who insisted that "whatever financial problems might arise elsewhere in the early 1980s, there should be no comparable debt crisis in Chile...." (Whitehead, p. 121) Chile's "neo-conservative experiment" had apparently solved many of its major economic problems. Unfortunately, these solutions also proved to be almost totally ineffective against some of Chile's other major problems.

For example, unemployment continued on a steady upward trend, even after all of the Chicago Boys' policies had been put into effect. In addition, the multitude of favorable indicators masked the problems that Chile was having with its balance of payments — especially after the introduction of the fixed exchange rate in June of 1979. The decision to peg the exchange rate at 39 pesos to the dollar was one of the most controversial decisions of the Pinochet administration, and many economists believe it to have been the policy most responsible for the onset of the debt crisis. Finally, in 1979 Chile saw a huge inflow of commercial bank credit entering its economy, which later provided Chile with an equally huge debt problem to deal with.

As one economist during the first decade of Pinochet's rule said in the *Wall Street Journal*, "I have never been in a country where for five years all the indicators were going in the right direction: exports, health, housing, income, infant mortality — you name it." (Schumacher, p. D4) However, although Chile was showing strong signs of economic prosperity during the late 1970s, the first cracks in the Chilean model were beginning to appear. Pinochet and his administration were convinced that the economic recovery that they had triggered was complete and permanent, and had confidence that their policy decisions were the correct ones. However, confidence has a tendency to turn into stubbornness when things begin to fall apart, which is exactly what the early 1980s brought on the eve of the debt crisis.

Full Stores and Empty Pockets: The Onset of Crisis

A *New York Times* headline from May 2, 1983, read: "Full Stores and Empty Pockets Tell Chile's Story." After enjoying annual growth rates of around 8 percent between 1977 and 1981 (to the delight of General Pinochet), Chile's GDP plunged by over 14 percent in 1982. Unemployment in the Santiago area had reached nearly 22 percent, and in the provinces was said to have reached 30 percent. Company after company collapsed under mountains of bad debt, and Chile's banks had become almost completely insolvent. Latin America's economic miracle was now facing more than $18 billion of foreign debt, rising inflation (once again), massive capital outflows, and a great sense of distrust that its people were developing towards the Pinochet administration. (Schumacher, p. D4) Before long, Pinochet found himself dismissing all 16 members of his cabinet on April 20, 1982, out of frustration and desperation. ("Chilean Cabinet is Dismissed") The entire continent, as well as the rest of the world, was left wondering how Chile, the so-called *wunderkind* of Latin America, had come to this.

Were the Chicago Boys completely wrong in their policy prescriptions for Chile? While Pinochet's economists did commit some critical policy errors, their free-market economic visions and suggestions certainly had potential. They did accomplish the desired reduction in inflation, and had put Chile on the path to economic prosperity. However, in an article entitled "Unintended Lessons from the Chicago Boys," Mrs. Lucy Schwank writes, "The misfortunes of the Chicago Boys... merely prove that free-market principles cease to work only when they are abandoned." (Schwank, p. 9) As the next section will illustrate, the introduction of Chile's fixed exchange rate — a decidedly non-free-market policy decision — would prove to be a major factor in bringing on the financial crisis.

"Latin America's Jinxed Bandwagon": The Fixed Exchange Rate

During the decade and a half following Chile's debt crisis, many of the possible causes of the crisis have been analyzed and debated. However, one recurring sentiment pervades most of the popular accounts of the crisis: Pinochet's decision to fix Chile's exchange rate at 39 pesos to the U.S. dollar was his administration's most serious policy error. Schumacher affirms this observation, stating that "the overwhelming consensus among government officials and economists today is that the beginning of the end began in 1979, when Sergio de Castro, then Finance Minister, imposed the fixed exchange rate...." (Schumacher, p. D4) It signaled the first real departure from the free-market policies that the Chicago Boys had implemented, and arguably triggered all of the other events leading to the collapse of the early eighties. Had Chile's exchange rate policy been handled differently, recession may not have been completely avoided, but at the very least it would have been much less painful.

Before 1979 Chile's exchange rate was frequently monitored and adjusted via a "crawling-peg" system. Up until mid-1976, the peso was devalued approximately two or three times per month. After a slight revaluation of 11 percent in 1976, the government switched to daily devaluations at a pre-announced rate. There were additional intermittent sudden revaluations, but for the most part this close monitoring of the exchange rate continued in a similar fashion during most of the 1970s. The principal goal of this intense supervision and adjustment of the nominal exchange rate stemmed from Chile's constant fear of inflation. After watching inflation soar above 600 percent during the years following the coup, Pinochet's administration took it upon itself to keep inflation under control at all costs. It is true that the inflationary effects of the tightly controlled peso devaluations were minimal, and by the end of the 1970s it did appear that Chile's long-standing inflation troubles had been defeated. Chile's official exchange rate remained fairly consistent with the market rate (the "real" exchange rate), and therefore its foreign exchange market was, for all intents and purposes, a free exchange market. (Whitehead, pp. 133-34) However, by 1979 Chile was still seeing annual inflation rates of 38.9 percent — lower than the ridiculously high rates of five years earlier, but still not acceptable to Pinochet and his Chicago Boys, who were more committed to anti-inflation policy than any other administration in Latin America at that time. Hence, in June of 1979 the fateful decision was made to peg the Chilean peso to the U.S. dollar at an official exchange rate of 39 pesos to the dollar. This somewhat anti-free-market decision placed an effective ceiling on any inflation Chile was to suffer and provided the additional benefit of instilling the confidence of a stable currency in the minds of foreign investors who were considering sending their funds to Chile. At first glance, it seemed to be a veritable stroke of genius. However, textbook economics shows that committing to such strong anti-inflation goals without regard to cost usually requires one to accept significant increases in unemployment, as well as to make sacrifices in terms of total output.

At the end of the 1970s, the U.S. dollar was rapidly declining in value, and was considered weak relative to the appreciating peso. U.S. President Carter's economic policies were helping keep the value of the dollar low in the international market. With the exchange rate at 39 pesos to the weak dollar, it didn't take very long for international investors to see the bargain. International reserves increased dramatically as Chile was flooded with the dollars of investors buying up the strong Chilean pesos. The interest rate on peso deposits in Chile had risen above the U.S. interest rate on dollar deposits. As the economy flourished, Pinochet gained credibility as a very capable head of state.

Though the 1980 presidential election in the U.S. may not have been an item of concern to most Chileans, hindsight reveals it to have been a critical turning point in Chile's economic well-being. Had President Carter been re-elected, the value of the dollar would have most likely remained weak compared to the Chilean peso, and the 39 pesos-per-dollar exchange rate would have continued to draw the dollars of international investors in waves. The Chilean peso would have continued in its role as a strong, reliable investment to hold. Unfortunately for Pinochet's policy makers, when President Reagan took office his announced goals for the nation included a commitment to keeping the dollar strong. His Federal Reserve Chairman, Paul Volcker, enforced a tight monetary policy; and as the dollar regained its strong position in the world market, Chile helplessly watched its peso weaken in the grip of the fixed exchange rate. (Schwank, p. 9)

What followed was no surprise. The

investment "bargain" was now the promise of one strong *dollar* for 39 weak pesos. Both Chilean and foreign investors quickly noticed this and traded in their weakening pesos for dollars. Capital inflows, after skyrocketing in 1979, started disappearing as quickly as they had arrived. This massive flight of what was, in actuality, merely speculative capital was disastrous to the banking sector of Chile. Net inflows of capital, which were a very encouraging 15 percent of GDP at the beginning of 1981, fell to a scant five percent of GDP by 1982. (Schwank, p. 9)

Looking back to June 1979, it is inevitable for one to consider whether this crushing blow to the Chilean economy would have occurred had the decision been made to continue floating the exchange rate, rather than to fix it. While it is true that Chile *had* become an attractive place to foreign investors during the late 1970s (relative to most of the countries in the region) due to its controlled inflation and steady GDP growth rates, the nation would not have seen anywhere near the deluge of foreign capital had the exchange rate been allowed to float at near-market rates. The majority of that spectacular 15 percent net capital inflow seen in 1981 was nothing more than purely speculative capital. It did not enter the country with the goal of building up enterprises through productive investment and was certainly not intended to remain in Chile for the long-term. The capital was attracted by the disparities resulting from the defense of the infamous fixed exchange rate. As soon as the advantage of holding Chilean pesos disappeared, the speculators withdrew their investments. Capital flight triggered by the U.S. monetary policy change would not have been as severe had the exchange rate been allowed to float, as floating exchange rates are generally self-stabilizing and do not place such enormous drains on international reserves. (Schwank, p. 9)

It is important to note that when the foreign capital disappeared, it left behind many problems with which Chile had to deal. After the exchange rate was fixed, international currency reserves had soared, as would be expected given the relative strength of the peso. In 1980 alone, such reserves in Chile rose by nearly 180 percent. However, to defend its fixed exchange rate, Chile found itself needing to inject nearly 70 billion pesos into the nation's money supply to buy up the immense amount of foreign currency. The chain-reaction results of such a move should have been clear to Pinochet's administration. Following the increase in the money supply, the majority of Chileans developed a fear of the country's dreaded inflation returning once again. During periods of expected inflation, a large increase in the demand for loans is generally observed. Savvy consumers, businesses, and the like will borrow money which still holds value today in the hopes of paying it back in currency which will be worth less by some future time, when those debts come due. This is exactly what occurred, setting the banks up for the banking crisis which started as early as late 1981. As expected, the inflation did hit, but not until the beginning of 1983 when it jumped back from the encouragingly low 9.5 percent of early 1982 to the more "normal" (for the Latin American region) 25 percent. Compounding the problem, savings began falling, once again due to the fear of inflation, and the nation's interest rate began a steady climb.

In effect, by implementing the fixed exchange rate policy, Chile had promoted, and in fact had encouraged, foreign investments that were too great for Chile's financial system to absorb. When foreign investment disappeared, the fixed exchange rate deterred, and in actuality "taxed," any additional investment. (Schwank, p. 9) But even while listening to the cries of Chilean businessmen, farmers, and others suffering from the loss of competitiveness in the international market brought about by his administration's exchange rate policy, Pinochet refused to devalue. A 1982 *Wall Street Journal* article quoted Pinochet's chilling warning to dissidents (italics added for emphasis): "The country has begun to overcome the crisis, showing the first signs of a revival that will be very slow at first, but will be sustained. *Those who fail to understand this will abide by the consequences.*" ("Chile's Pinochet Says Recession Easing")

Fueling Pinochet's stubbornness were both his finance minister, Sergio de Castro, who had created the fixed exchange rate, and the president of Chile's central bank, Alvaro Bardon.

Bardon pointed out that the recession in Chile had reduced imports and created a low inflation rate, which should have increased the competitiveness of Chile's exports. He made frequent visits to New York banks attempting to convince them to extend more credit to his country, asserting that "[the U.S.] will see us begin to recover in three or four months, independently of what happens with the U.S. economy." (Martin) A peso devaluation would only spark a rash of inflation, he argued. However, even as U.S. critics cried out about the distortions that a fixed exchange rate can cause in an economy, citing as proof the continuing deterioration of Chile's economic situation, bankers remained eager to push Chile towards their goal of a free-enterprise economy and continued to lend. One such U.S. banker, still intent on loaning to Chile as late as 1982, predicted with confidence: "They are going through a shakeout that was almost deliberately set up. The government wants only those companies that have a comparative advantage in world competition to survive. We will see a recovery by 1983, definitely. What will come out will be a stronger private sector and the whole experiment will be fully successful." Unfortunately, what actually ensued painted quite a different picture. (Martin)

The Failure of the Banking Sector

By 1982 interest rates had become extremely high once again, and the weaknesses in the banking sector became painfully evident. One of the major steps taken by the Chicago Boys towards financial liberalization was the privatization of Chile's banking system, intended to stimulate savings and investment and to further the pursuit of a true free-market system. Unfortunately, what was actually seen was a drop in savings from about 16 percent of GDP during the 1960s to about 12.4 percent between 1975 and 1981. A significant drop in the level of investment was observed during the same period as well. The principal explanation for these unintended results of the privatization experiment was the decision to eliminate all of the credit controls that had initially been put into place to direct capital into production, rather than into pure consumption. This sudden freedom triggered a massive increase in consumption, especially among Chile's middle class — an increase which was satisfied by an equally large increase in imports, damaging Chile's trade balance. (Whitehead, p. 127)

Debtors of the time period seemed oblivious to the losses they were suffering due to the high interest rates on their borrowed money. At these high interest rates, banks were very willing short-term lenders, and these debtors found that the alternative to facing up to their debts was to borrow more. Incredibly, the *interest* alone accumulated on peso loans between 1977 and 1982 accounted for over 70 percent of the peso debt that remained outstanding by the end of 1982. As this overlending epidemic spread, debtors began to realize that their troubles were a part of a greater crisis — a realization which weakened their incentive to take action to fix their individual problems. This behavior, though destined to ruin the banking system, was continued as debtors assumed that a typical Chilean wave of inflation would bring negative real interest rates which would save them from their debt.

At this point, one begins to question the nature of the relationships between debtors and creditors in the Chilean financial system. In a normal, solid financial system, there is the constant requirement of *transparency* — all participants are "reasonably well informed" about each other's expected behavior. It should not take much time for creditors to realize when a potential recipient of additional credit is in fact no longer creditworthy. However, this sort of transparency simply did not exist in Chile, in no small part due to the nature of Pinochet's reign itself. Under Pinochet, the situation was such that Chileans "did not have the right to know what the authorities wished to conceal, and the courts assumed the impunity of the most powerful, so why should it be any different in the realm of finance?" (Whitehead, p. 128) The recipients of the over-extensions of credit were Chilean enterprises who were well aware of this sort of financial environment, bizarre as it may have seemed. The lenders, on the other hand, were to a large degree foreign bankers, with no sense of the non-transparent Chilean financial sector. The combination of the ignorance of foreign lenders to the impending banking disaster and the perhaps too-rapid financial liberalization, which proceeded without any type of restraint, led to the collapse of the Chilean financial sector. Even on the eve of the crisis, most foreign creditors were still unaware that the majority of the Chilean debtors to whom they were lending were completely uncreditworthy.

By May 1981, CRAV, one of the largest privately owned firms in Chile, declared bankruptcy, triggering the fall of many smaller firms and banks. By the end of 1981 Chile announced that its financial institutions were $2.5 billion in debt, more than twice the total amount of capital possessed by all of them. Banks were making unreasonable loans to their owners and were suffering from the overlending that had taken place during the boom in capital inflows at the end of the 1970s. As mentioned earlier, 1982 saw GDP fall by a disastrous 14.3 percent. During the course of the next few years, Chile's Central Bank was forced to absorb the debt of the private banking system, a policy decision it had earlier promised not to make, emphasizing the merits of privatization. By 1985, 14 of the 26 national banks and 8 out of 17 financial institutions were under state control — quite ironic, given the government's commitment to a reduction in state control of such institutions. (Martinez and Diaz, p. 59) Pinochet, who had sworn not to devalue Chile's currency from the fixed exchange rate of 39 pesos to the dollar, approached his finance minister on March 24, 1983, under pressure from the IMF, with the words "I have decided to devalue." In effect, these actions constituted an admission on Chile's part that it was in deep financial trouble and desperately needed help. Along with the IMF, the World Bank also took notice of Chile's dire situation and stepped in to set Chile on the road to financial recovery through a complete restructuring of its financial system.

The World Bank's Four Projects: Recovery from Crisis

After the initial shock of the crisis had passed, Chile was able to step back and analyze its current economic situation. During the years in the aftermath of the crisis, Chile's government moved swiftly to implement major policy reforms and to restructure institutions. This was in no small part aided by huge amounts of lending from the World Bank. The World Bank granted loans to Chile to fund four targeted projects aimed at rebuilding the nearly ruined Chilean financial system. These projects were essentially allocations of money to the sectors of Chile's economy that could most benefit by them. The World Bank's loans to Chile were designed to accomplish three similar aims and objectives, against which their success or failure could be measured. First and foremost of these objectives was to simply aid the Chilean government in dealing with a steadily worsening recession that was taking a serious toll on the financial well-being of the country. Secondly, the Bank had observed Chile's recent struggles with failure in medium- and long-term financing and was hoping to improve the situation through intervention. Finally, the financial sector itself was in grave need of assistance, and, in fact, a thorough restructuring. (OED Précis) The World Bank looked to provide the means for such structural adjustments. Through analysis of the four projects, it can be seen how difficult it is to structure and initiate an effective plan of recovery in the midst of a crisis, when the benefits of experience and hindsight are non-existent. However, with each project important lessons were learned as to the proper design of such undertakings, and as a result successive attempts were increasingly more successful.

Industrial Finance Restructuring Project

As previously stated, immediately after the height of the banking crisis in 1982-1983, the Chilean government stepped in to rescue its banks from certain disaster. By guaranteeing deposits and providing large amounts of emergency liquidity assistance to the private banks most in need of help, many institutions were saved from the brink of insolvency. However, the system was left in a state of disrepair. Foreign debt was dangerously high, and uncertainty was running rampant among the surviving banks as well as the policy makers of the country. Realizing that outside help was the only remaining solution, Chile approached the World Bank with a request for assistance. The

Bank responded with the Industrial Finance Restructuring Project (IFRP), a loan in the amount of $100 million. Initialized in parallel with the IFRP was the $40 million Small and Medium Industry Project (SMIP), the second Bank loan approved in 1985. (OED Précis)

The IFRP had as its principal objective the overall financial restructuring and strengthening of large industrial firms, aimed at encouraging fixed investment and developing a permanent working capital base. A technical unit was set up in the central bank in order to provide assistance in corporate restructuring, as well as to control and manage the financing of firms that wished to receive this aid.

The idea for the IFRP was actually conceived in 1983, when Chile was still in the proverbial eye of the storm and the recession was in full swing. The industrial sector was believed by many to be inches away from complete bankruptcy, and therefore the project was carefully constructed to provide both financial restructuring as well as the means for investment in new plants and new equipment to place these floundering industries on an upward track. However, the Bank assumed that the already weakened industries would be able to perform dramatic restructuring while handling the influx of new loans for the purpose of plant expansion. In a recent report, the Bank conceded that "from the start, this unusual design hindered the implementation of the project." (OED Précis)

During the two years it took to bring the loan from conception to reality, economic conditions in Chile had changed substantially. By 1985 Chile was well on its way out of the recession, and there were many signals of economic recovery showing up throughout the country. However, the IFRP was *never* redesigned, or even re-evaluated, to take into consideration the changed (and indeed, improved) economic environment. It took until May of 1987 for the World Bank to make changes to the rules for loan dispersal. Previously, the IFRP had required struggling industries to go through a thorough financial restructuring before they would receive any aid for standard industry projects and new equipment. Under these conditions, the Bank received very few requests for loans through the IFRP. However, after the conditions were changed to allow industrial companies to finance projects *without* restructuring, the loans were quickly requested and distributed. (OED Précis)

Small and Medium Industry Project

Conceived at approximately the same time as the IFRP was the Small and Medium Industry Project (SMIP) in the amount of $40 million. Its principal goal was the reduction of Chile's high unemployment by giving assistance to small- and medium-sized companies, in the hopes of creating more job opportunities and promoting expansion. However, according to Imogen Mark, correspondent for the *Financial Times* in Chile, the project was "mostly political, to keep workers happy after the devaluation of the peso." (Mark) Many of these small-to-medium sized enterprises were the ones that got hit the hardest when Pinochet agreed to devalue the Chilean peso, leaving many workers displeased with their situation. It was a reactionary measure that perhaps needed better planning before its implementation.

What the SMIP correctly determined was that the main obstacle to capital acquisition faced by these small enterprises was simply market failure in the medium/long-term lending capital market. In one respect, the SMIP did alleviate some of the problems dealing with lack of strong medium/long-term lending practices with its introduction of "risk-capital" funds. Basically an experiment in venture capital, what these were supposed to do was provide new companies and enterprising individuals with access to equity and working capital in order to encourage the growth of the SME (small-to-medium enterprise) sector. Confused by the astonishingly low demand for these funds when they were introduced, the World Bank failed to notice that Chile's track record was virtually devoid of any type of venture capital operations. As a result of the economic shake-ups of the late 1970s and early 1980s in Chile, most of the country's financial institutions had become strongly risk-averse. (OED Précis)

From this observation, another question arises — were Chilean enterprises and individuals well-educated enough to be risk-averse? This observation, made by Imogen Mark during an interview with the author in Chile, stems from the fact that the over-lending practices of the early 1980s seem to indicate that "people are convinced that they can get away with crazy things." (Mark) In addition, with no history in venture capital, Chile was largely uneducated as far as how to make it work for its struggling SME sector. Mr. Vladmir Radovic, a director of the Chilean branch office of the Inter-American Development Bank (IDB), further confirmed this underlying problem with the SMIP, indicating that there is *still* very little investment in new companies in Chile. Only recently, more than a decade after the Bank projects were set into motion, has the IDB taken steps to introduce a venture capital fund to Chilean small enterprises. The Multilateral Investment Fund administers grants to innovative projects in the private sector which need an initial source of capital. However, so far the only loans have been granted to *existing* groups, such as mining companies. As was observed in the aftermath of the SMIP, there have been very few loans granted to *new* companies for expansionary investment. (OED Précis)

Industrial Finance Project and Financial Markets Loan

The partial failures of the first two projects set the stage for the improved design of the other two Bank projects — the Industrial Finance Project (IFP) and the Financial Markets Loan (FML). Both were redesigned as a result of the lessons learned from the IFRP and SMIP. The $75 million IFP was designed as a cousin of sorts to the IFRP, aimed at providing medium- and long-term financing for industrial enterprises, but with more emphasis placed on building up medium-size firms by offering investment opportunities. The FML, on the other hand, had somewhat different goals from the other three projects. $100 million was granted to the Chilean government, not only to strengthen and provide medium-term financing opportunities, but principally to reinforce and "deepen" the securities markets. (OED Précis)

Impacts/Outcomes of the Four World Bank Projects

More favorable economic conditions and the experience of two less-than-successful projects contributed to the greater effectiveness on the whole of the IFP and the FML. In addition, the IFRP and the SMIP did, as the World Bank reports, "provide long-term financing of viable investment projects at a time when no other significant sources of financing existed," and did help stimulate the economic recovery. (OED Précis) By the end of the 1980s, firms which had received loans out of the IFRP were seeing increases in revenues of more than 50 percent per year. In addition, the SMIP benefited over 1,700 small-to-medium sized enterprises, most of whose newly created investments were indeed profitable. The "investment momentum" created in the medium-to-large enterprise sector with the introduction of the IFRP was preserved with the arrival of the IFP, which ensured continual growth through encouragement of additional investments. The businesses receiving its aid experienced a general increase in profitability, and the loans stimulated these companies to begin exploring non-domestic markets, such as MERCOSUR. (OED Précis)

However, the strengthening of the financial sector that these loans attempted to accomplish wasn't entirely realized. Many of these loans benefited only the weaker banks, who took the loans mainly because borrowing in the financial market was much more costly due to risk adjustments. Secondly, the SMIP saw the participation of very few commercial banks — in fact only 28 of the loans dispersed passed through the commercial banking system. On the other hand, the FML was considered a great success, which contributed to rapid growth of Chilean pension funds, life insurance companies, and the securities exchange. Pension fund real assets nearly tripled between 1989 and 1994, and the number of stocks on the exchange has grown substantially. (OED Précis)

Finally, both the banking and corporate sectors have become much stronger institutions through careful monitoring after the crisis had subsided. The government formed commissions to step in and watch over the firms that had been nationalized during the crisis, planning their eventual reprivatization. In addition, in 1987 a new banking law was created which demanded greater transparency in the activities of Chile's banks and other lenders, thus addressing the major flaw in the Chilean system. The law also replaced the state's unconditional deposit guarantees with a more controlled guarantee system that would require the sharing of risk by shareholders, bank creditors, and depositors, in addition to the state. The Central Bank suffered heavy losses during its bailout of the banking system (11 percent of GDP during 1985 and 1986), but the new banking regulations strengthened the system and insured it against another crisis of such magnitude. (Moran, p. 477)

Conclusions

In only one decade, Chile's banking system, and in fact its entire financial sector, was turned around from near bankruptcy into the success story of Latin America. In fact, Chile has emerged as one of the most attractive capital markets to investors in the region. The Chile of the 1990s has been a symbol of renewed economic hope and prosperity. Once again, Chile has been consistently ahead of its neighbors with respect to GDP growth, according to statistics presented by Hans Rudolf, International Finances Coordinator in Chile, during an interview with the author. Current rates of annual inflation are near 6 percent — normal for most developed countries, but truly spectacular for Latin America — and Chile is still working to reduce inflation even further to reach the levels of industrialized economies. (Rudolf) Partially responsible for these encouraging figures was the 1990 decision to make the Central Bank of Chile completely independent of the federal government. All decisions on monetary policy are now made outside of the government, bringing to mind the image of Pinochet stubbornly refusing to abandon his fixed exchange rate while the Chilean economy spiraled downward. Since the end of the 1980s, Chile has enjoyed more than a decade of fiscal surplus, and government expenditures have decreased significantly after peaking in 1982 (when the government bought up the non-performing portfolios of many of Chile's banks). (Rudolf)

Can this sort of growth continue in Chile without terminating in crisis again, as was seen in the late 1970s? Signs are certainly promising. Chile's rate of savings has increased to 24 percent — while the remainder of Latin America averages about 15 percent. Statistics show that this domestic saving is also leading to increased domestic investment — *constructive* investment in new facilities, which is creating more than enough capacity for Chile to grow in the future. In addition, to discourage the type of rapid inflow and outflow of speculative capital that spelled disaster for Chile in the 1980s, Chile implemented a tariff on short term capital during the 1990s which was only recently relaxed. The regulation mandated that Chile keep a certain percentage of all capital entering the country for a full year after its entry, regardless of when the investment was pulled out, thereby creating a "tax" on short-term capital, encouraging long-term investments and reducing the overall volatility of foreign investment.

In conclusion, whatever problems exist in Chile's economy today pale in comparison to the problems of the late 1970s and early 1980s. The Chile of today presents a far more stable financial environment and promising outlook on the future than during the dark days of its debt crisis. Investors worldwide recognize the opportunities that Chile can provide and have far more confidence in sending their funds to the once-troubled Latin American nation. The dropping of the "tax" on short-term capital and the reduction of import tariffs are strong indicators that Chile has moved beyond the repair and recovery phase, and is poised to move onward and upward in the global marketplace.

REFERENCES

"Chilean Cabinet is Dismissed." *New York Times*. April 20, 1982, p. A8.

"Chile's Pinochet Says Recession Easing, Warns Against Dissent in Period of Economic Recovery." *Wall Street Journal*. March 14, 1983.

Mark, Imogen. Personal interview with the author, June 4, 1998, Santiago, Chile.

Martin, Everett G. "Chile's Shakeout Scares Some Banks." *Wall Street Journal*. March 16, 1982.

Martínez, Javier and Alvaro Díaz. *Chile: The Great Transformation*. Geneva, Switzerland: The United Nations Research Institute for Social Development (UNRISD), 1996.

Moran, Cristian. "Chile: Economic Crisis and Recovery," in Vinod Thomas, ed. *Restructuring Economies in Distress: Policy Reform and the World Bank.* New York: Oxford University Press, 1991.

Operations Evaluation Department (OED Précis). "Financial Restructuring in Chile." World Bank website: http://www.worldbank.org/html/oed/pr101.htm.

Radovic, Vladmir. Personal interview with the author at the Inter-American Development Bank, June 4, 1998, Santiago, Chile.

Rudolf, Hans. Remarks to the Martindale group, June 1, 1998, Santiago, Chile.

Schumacher, Edward. "Chile's Fast Economic Slide Triples Unemployment Rate." *New York Times*. April 25, 1983, pp. A1 and D4.

Schumacher, Edward. "Full Stores and Empty Pockets Tell Chile's Story." *New York Times*. May 2, 1983.

Schwank, Lucy. "Unintended Lessons from the 'Chicago Boys'." *Wall Street Journal*. December 23, 1983, p. 9.

Whitehead, Laurence. "The Adjustment Process in Chile: a Comparative Perspective." *Latin American Debt and the Adjustment Crisis*. Great Britain: The Macmillan Press, Ltd., 1987.